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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL, NORTH-SOUTH CAROLINA
DISTRICT, GREENSBORO
CC: SET:NCS:GBO
Attn: Steven M. Webster, Senior Attorney

FROM: Deborah Butler
Assistant Chief Counsel (Field Service) CC:DOM:FS

SUBJECT: Sale of Stock under Installment Method

This Field Service Advice responds to your memorandum, dated July 14, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND::

Mr. X =
Mr. Y =
Mr. Z =
Corp A =
Corp B =
Corp C =
Corp D =
b =
c% =
$d =
$e =
$f =
g =
$h =

i%	=
$j	=
$k	=
$m	=
$n	=
$o	=
$p	=
$q	=
$r	=
$s	=
$t	=
$u	=
v%	=
w%	=
$x	=
$y	=
$z	=
$aa	=
bb	=
Calendar Year 1	=
Calendar Year 8	=
Calendar Year 9	=
Calendar Year 10	=
Tax Year 1	=
Tax Year 2	=
Tax Year 3	=
Tax Year 4	=
Tax Year 5	=
Tax Year 6	=
Tax Year 7	=
Tax Year 8	=
Tax Year 9	=
Tax Year 10	=
Tax Year 11	=

ISSUE::

The correct treatment in Tax Year 12 of final payments made to settle an earlier buyout agreement of stock owned by the taxpayer, Mr. X.

<u>CONCLUSION:</u>:

The buyout agreement executed in Tax Year 1 should be treated as a contingent installment sale. Basis should have been recovered ratably in accordance with Temp. Treas. Reg. § 15.453-1(c)(3). The payments made in Tax Year 12 should be treated as disposition of an installment obligation under section 453B(a)(1). In addition, the charitable contribution of an interest in the buyout agreement would produce a disposition under section 453B(a)(2).

<u>FACTS:</u>

Background

In Calendar Year 1, Mr. Y and Mr. Z formed Corp A to own and operate
serving the general public. Corp B was formed as the operating company

One of the first business entities
was owned by Mr. X. Mr. X expressed an interest in the business and became involved
while Mr. Y handled the business entities and other operations.

From Corp B's inception, Corp C owned most of Corp B's stock and Corp A owned the rest. Corp C later became Corp D. Mr. X acquired stock in Corp D while he was employed by Corp B and eventually accumulated b shares. Mr. X worked for Corp B until about Calendar Years 9 or 10. Apparently, Mr. X became dissatisfied with the way the business was being run and left the company.

There is evidence that Mr. X was instrumental in the developmental stages of Corp B,
In addition, there is evidence that Mr. X was involved in fending off a hostile takeover in Calendar Year 8. Mr. X may have acquired many of his shares in Corp D during the takeover attempt.

Agreement in Tax Year 1

Early in Tax Year 1, Corp D was merged into Corp A, which became the sole stockholder of Corp B. Under the merger agreement, each share of Corp D Common Stock would be exchanged for one share of Corp A Special Common Stock. Prior to the merger, Mr. X owned c% of the Corp D Common Stock. Although Corp D Common Stock was not appraised at the time of the merger, records show that it was purchased by the public the year before for a low of $d and a high of $e per share. Other known transactions in that year, including shares purchased and sold by officers and directors of the corporation, show the stock reached a high of $f per share.

Mr. X was dissatisfied with the merger. Accordingly, he exercised dissenter's rights to the merger and elected to receive the "value" of his shares of Corp D Common stock. Negotiations ensued and Mr. X and Corp A entered into the settlement agreement which provided the following would be paid to Mr. X:

> 1. A g-year $h unsecured promissory note paying interest only at i% per annum;
>
> 2. Amounts labeled as "Bonus Compensation" in the agreement to be made for the period during which the note was outstanding and equal to a one-time payment of $j, plus an annual payment, which apparently was equal to c% of Corp B's annual net after tax earnings in excess of $k. , to be made for the period during which the note was outstanding.

The Bonus Compensation provision stated that it was additional compensation for past and future services to Corp B and in recognition of Mr. X's contribution to the past success of Corp B and for the valuable consideration reflected in the agreements of Section 4 .

Section 4 is titled "Goodwill and Support of [Mr. X]" and reads as follows:

> [Mr. X] agrees that for so long as the Note is outstanding, he will support the management of [Corp B] and not take any action that may damage the business reputation of [Corp B] or interfere with the ongoing business of [Corp B] in any way. [Mr. X] acknowledges and agrees (i) that his agreement in this regard is an important consideration to [Corp A] with respect to [Corp A's] obligations under Section 2 hereof; (ii) that [Corp A] would not have included in this Agreement the terms contained in Section 2 hereof if this agreement was not explicitly a provision hereof . . .

There is no evidence that Mr. X performed any services to Corp B or Corp A after leaving the Corp B prior to the merger, other than to offer his unsolicited advice occasionally. There was no requirement under the agreement that Mr. X perform services in the future.

Corp A paid Mr. X interest on the note in Tax Years 1 though 11. In addition, it paid the following amounts under the Bonus Compensation provision.

Tax Year 1 - $m
Tax Year 2 - $n
Tax Year 3 - $o
Tax Year 4 - $p
Tax Year 5 - $q
Tax Year 6 - $r

In Tax Years 7 though 11, no amounts were paid under the Bonus Compensation provision. There is evidence that Mr. X did not report any of the payments attributable to the Tax Year 1 agreement on his returns for Tax Years 1 through 11.

Agreement in Tax Year 12

Under the terms of the note, which were incorporated into the Tax Year 1 agreement, either party could "call" the agreement after bb years with a "prepayment premium" based on a formula incorporating the Bonus Compensation provision. Late in Tax Year 11, Corp A decided to call the note in accordance with its terms. Negotiations ensued but Mr. X appeared unwilling to have the note called under any circumstances. There is evidence that Mr. X believed he had an informal promise from Mr. Y that the note would remain outstanding until maturity and that he considered himself to still be a stockholder in Corp B with a c% ownership interest. His counteroffers for accepting the call were based on his receiving c% of the total value of Corp B, which was estimated to be from $s to $t.

Mr. X also contended that Corp A was in breach of the Tax Year 1 agreement. He asserted that Corp B had begun to pay Corp A unreasonable management fees subsequent to the Tax Year 1 agreement which directly affected his Bonus Compensation payments. Mr. X apparently argued that the management fees were an unreasonable intercompany expense that should have been reversed before calculating the yearly Bonus Compensation payments. If Mr. X was correct, he was due roughly $u in additional payments under the Bonus Compensation provision for the Tax Years prior to Tax Year 11.

Corp A contended that the management fees paid by Corp B to Corp A were reasonable payments for the leadership, guidance, and management services provided by a parent to its subsidiary during a difficult period in the corporate history. In recent years, Corp B was under intense competition pressures.

In Tax Year 12, Mr. X created what has been characterized as a charitable remainder unitrust (Trust A) and a charitable trust (Trust B). Mr. X transferred into the trusts his interest in the Tax Year 1 agreement, excluding his rights in the promissory note, and his rights to the Bonus Compensation payments. Trust A received a v% undivided interest in the described property, and a charitable trust received a w% undivided interest. It is not clear what rights to payments Mr. X had under Tax Year 1 agreement, other than those excluded from the contribution.

An agreement regarding settlement of claims was reached later in Tax Year 12. Those representing Corp A and B decided it was in the best interest of those corporations to pay $x to end the matter. Their decision, in large part, was influenced by Corp A learning that Mr. X intended to donate, through the two trusts, a substantial portion of the settlement to a local educational institution. The Tax Year 12 settlement agreed upon the following amounts:

$h	Paid pursuant to the promissory note
$y	Paid pursuant to the prepayment premium based on the Bonus Compensation provision
$z	Paid under the "remaining provisions" of the Tax Year 1 agreement to fund the two trusts
$x	

With respect to the "remaining provisions" aspect of the Tax Year 12 agreement, the document provides that the amounts -

> shall be paid . . . in complete satisfaction of the disputes relating to [Corp A’s] obligations under the remaining provisions of the [Tax Year 1] agreement excluding [Corp A's] obligations under the Note and Paragraph (2)(a) of the [Tax Year 1] [a]greement.

Mr. X reported $h and $y as capital gain items on his Tax Year 12 federal income tax return. He also claimed a basis of $aa, which was apparently his basis in his stock.

LAW AND ANALYSIS:

Installment sale

As a general rule under section 453(a), income from an installment sale is taken into account under the installment method.

Section 453(b)(1) defines “installment sale” to mean a disposition of property where at least 1 payment is to received after the close of the taxable year in which the disposition occurs. For the purpose of section 453(b)(1), payments do not include evidences of indebtedness of the purchaser that are not payable on demand, readily tradeable or unsecured. See I.R.C. § 453(f)(3); Temp. Treas. Reg. § 15A.453-1(b)(3)(i).

The Tax Year 1 agreement is an installment sale because at least one payment attributable to the sale of the stock (at the very least, the payment on the note) was to be received after Tax Year 1, the year of the sale.[1] The term installment sale includes dispositions from which payment is to be received in a lump sum in a taxable year after the year of sale. Temp. Treas. Reg. § 15A.453-1(b)(1)

Section 453(c) defines “installment method” to mean a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total price.

Contingent Payment Sale

A contingent payment sale is a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of the taxable year in which that sale or other disposition occurs. Treas. Reg. § 15A.453-1(c)(1). The sale occurring in Year 1 in the present case would be a contingent payment sale because of the payments contingent on the net income of Corp B. Prior to the Enactment of the Installment Sale Revision Act in 1980 (P.L. 96-471), a sale for a contingent price did not qualify as an installment sale. S. Rept. No. 1000, 96th Cong., 2d Sess. 22 (1980), citing Gralap v. United States, 458 F.2d 1158 (10th Cir. 1972); In re Steen, 509 F.2d 1398 (9th Cir. 1975). The Act enacted I.R.C. § 453(j), which required the Secretary to prescribe regulations which provide for the ratable basis recovery in transactions where the gross profit or the total contract price (or both) cannot be readily ascertained.

Because of the contingent payments, no maximum selling price for the stock could be determined by the end of Tax Year 1. However, the maximum period over which payments would be received was known, that is, the period of the note or b years. Under the regulations, when a stated maximum selling price cannot be determined as of the close of the taxable year in which the sale or other disposition occurs, but the maximum period over which payments may be received under the contingent sale price agreement is fixed, the taxpayer’s basis (inclusive of selling expenses) shall be allocated to the taxable years in which payment may be received under the agreement in equal annual increments. Temp. Treas. Reg. § 15A.453-1(c)(3)(i). Therefore, Mr. X should have been recovering 1/g of his basis in the stock each year. That part of the installment obligation, that is, the part represented by the note, is fixed and part of the obligation is contingent does not change this result. See Temp. Treas. Reg. § 15A.453-1(c)(3), Ex. (4).

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[1] The prohibition currently found in section 453(k)(2)(A), which denies the use of the installment method to certain stocks and securities is not applicable to sales occurring in the tax year in question.

However, in several taxable years, Mr. X received no payments, except interest, although Bonus Compensation payments were provided for each year. Temp. Treas. Reg. § 15A.453-1(c)(3)(i) provides that, if no payment is received or the amount of the payment received (exclusive of interest) is less than the basis allocated to that taxable year, no loss shall be allowed except in circumstances not relevant here. When no loss is allowed, the unrecovered portion of the basis allocated to the taxable year shall be carried forward to the next succeeding taxable year. Id. Thus, under the facts presented, the part of the basis that otherwise would have been allocable to Tax Years 7 through 11 will be carried over to Tax Year 12.

Election Out of the Installment Method

Under section 453(d)(1), section 453(a) does not apply to any disposition if the taxpayer elects to have it not apply. Under the regulations, unless the taxpayer elects not to report the sale on the installment method, a contingent payment sale must be reported on the installment method. See Treas. Reg. § 15A.453-1(c)(1).

Section 453(d)(2) states that, except as otherwise provided by regulations, an election under section 453(d)(1) may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer's return for the taxable year in which the disposition occurs. Temp. Treas. Reg. § 15.453-1(d)(3)(i) requires that the election be made in the manner prescribed by the appropriate forms for the taxpayer's return for the taxable year of the sale. A taxpayer who reports an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs will be considered to have made an effective election out of the installment method. Id.

There is no evidence the that Mr. X made a qualifying election out of the installment sale method.

Disposition of an installment obligation

Under section 453B(a), if an installment obligation is satisfied at other than its face value or distributed, transmitted, sold or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and (1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or (2) the fair market value of the obligation at the time of distribution, transmission or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange. Any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

Section 453B(b) defines the basis of an installment obligation as the excess of the face value of the obligation over an amount equal to the income which would be returnable were the obligation satisfied in full.

It is clear under the regulations that a installment obligation can contain both a fixed amount component and a contingent component as does the installment obligation in the present case. See Treas. Reg. § 15A.453-1(d)(2)(iii). In short, the Tax Year 1 agreement is an installment obligation.

Mr. X gave an interest in the Tax Year 1 agreement to Trusts A and B. The contribution of a installment obligation to charity is considered a disposition. Rev. Rul. 79-371, 1979-2 C.B. 294. As a result, Mr. X would have a gain calculated under section 453B(a)(2) and section 453B(b) when the contribution was made. Mr. X would also have a gain calculated under sections 453B(a)(1) and 453B(b) when the installment obligation is subsequently paid off under the Tax Year 12 agreement at an amount other than face value of the note. Under the flush language of section 453(a), the character of the gain will be determined by the nature of the property sold in Tax Year 1.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

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DEBORAH A. BUTLER

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